Addressing the Symptoms and Ignoring the Causes: A View from Wall Street on Dollarization

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Overview

In the late 1990s. dollarization received serious consideration across Latin America. During the past year, the Argentine and Ecuadorian governments proposed a shift to the dollar. Other countries, including Mexico, debated the policy. Dollarization is an interesting concept. It can provide immediate results to countries facing macroeconomic distress. A shift to the dollar allows a rapid reduction in the inflation rate, as well as a drop in nominal interest rates. However, dollarization does not address the imbalances or structural flaws that underlie the macroeconomic problems. Proponents argue that dollarization will buy the time needed to implement the necessary reforms or it will tie the government's hands in order to force the adjustments. Unfortunately, this is just wishful thinking. Although dollarization fits nicely within the conceptual boundaries of macroeconomics, it falls short of providing a realistic policy solution to institutional problems.

The Argument

Proponents argue that dollarization limit the range of policy discretion. Specifically, it accomplishes three major objectives[1]. First, it eliminates the lender of last resort. Second, it restricts the government's ability to implement monetary policy. Third, it eliminates seignorage. The arguments are straightforward. The replacement of the local currency unit with the dollar stabilizes nominal prices, including the inflation rate, exchange rate and interest rates. Few people dispute this. However, price stability will be sustainable as long as the government follows through with the necessary reforms to support the program. Otherwise, dollarization becomes a monetary illusion that fades quickly. Proponents of dollarization see the policy as a panacea. However, it addresses only the symptoms associated with macroeconomic mismanagement, rather than the root causes.

[1] Guillermo A. Calvo, Testimony on Full Dollarization, Presented Before a Joint Hearing of the Subcommittees on Economic Policy and International Trade and Finance. Washington, DC, April 22, 1999.

Fiscal Problems are Usually at the Root of All Evils

Price instability, characterized by a high rate of inflation and a rapidly devaluing exchange rate, is symptomatic of macroeconomic mismanagement. It reflects a collapse of fiscal discipline or a lack of coordination between the fiscal and monetary policies. Policymakers employ monetary policy to disguise or mitigate the consequence of a lax fiscal stance. Governments use an infinite range of options in order to circumvent a balancing of the fiscal accounts. However, the most common is the expansion of the money supply or an increase in domestic and foreign debt.

It is important to point out that political leaders face two counteracting forces when designing fiscal policy. The first force is the desire to spend. Politicians benefit from increases in government spending, particularly if it favors allies or key constituents. However, politicians also have to contend with the need to pay for the expenditures. This is known as the budget constraint. Increases in spending must be covered by increases in taxes. While increases in spending create political benefits, higher taxes carry political costs. Conceptually, these two political forces should neutralize each other. Hence, the politician should not generate any net-benefits from increasing government spending. Unfortunately, politicians find ways to circumvent the budget constraint through the manipulation of monetary and exchange rate policies.

The Latin American Experience

Latin American countries experienced serious fiscal problems in the 1980s after they lost access to the international capital markets. The plunge in foreign investment led to a reduction in gross fixed investment, a decline in the GDP growth rate and a contraction in tax revenues. At the same time, most of the Latin American governments were transitioning to democratic regimes from authoritarian rule. The new regimes were under intense pressure to channel resources to key constituencies. Unfortunately, the political leaders lacked the clout to increase taxes. Policymakers found a temporary solution through the use of monetary policy. The governments also found other ways to circumvent their budget constraints. For example, they created new pension and social programs, while keeping much of the costs off the fiscal accounts. The costs of these programs became apparent several years down the road, often past the tenure of the politician who designed the program. Nevertheless, these obligations helped fuel the overall level of macroeconomic instability.

In the 1990s, social scientists began looking for the factors that explained policy mismanagement. Most of the problems were traced back to flawed institutional designs. For example, the political systems of many Latin American governments lacked feedback mechanisms whereby policymakers, or political parties, were held accountable for policy actions. There were no independent agencies to provide opinions on fiscal policy choices. Most of the countries lacked an independent central bank. Development specialists found that groups took advantage of institutional flaws to maximize rents. In an effort to address these problems, the multilaterals began dedicating resources to studying institutional design.[2]

Unfortunately, dollarization is a shift away from fixing institutional design. Proponents of dollarization argue that the stabilization of the macroeconomic variables can lead to the emergence of a new institutional framework. This is a backward solution to the problem. Unfortunately, the logic is flawed. It is hard to imagine how dollarization can force a government to repair deep-rooted institutional problems. Rent-seeking groups do not willingly give up their privileged positions because of a new exchange rate regime. The absence of an enforcement mechanism that precluded fiscal discipline in the first place will continue to shape future policymaking. Indeed, economists who argue in favor of dollarization often base their prospects for change on hope. They hope that governments will exercise fiscal discipline once they encounter the constraints of dollarization.

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[2] Burki, Shahid Javed and Guillermo Perry Beyond the Washington Consensus: Institutions Matter Washington, D.C., World Bank, 1998.

Ironically, dollarization could exacerbate some of the policy misalignment encountered prior to the dollarization. A lack of inter-temporal accountability is one of the common institutional flaws in developing countries. In other words, changes in administration often lead to a complete, or large, turnover in government officials, including central bank staff, finance ministry and the congress. Therefore, the time horizon of policymakers tends is limited to the term in office. It is no surprise that these policymakers are attracted to alternatives that stabilize macroeconomic variables long enough to keep the administration afloat until the end the term without really having to fix the underlying institutional flaws. That is why dollarization has been appealing for governments in distress. However, it is hard to believe that any country would realistically pursue a long-term dollarization strategy. There are several arguments against a long-term dollarization initiative.

1. **Governments still need to fix the institutional problems that got them into trouble.** Governments will need to balance the fiscal accounts. Moreover, they will need to generate sufficiently large fiscal surpluses to restore investor confidence and pay down debt obligations. They will also need to recognize all off-balance sheet liabilities, such as pension and banking obligations.
2. **Dollarization tends to be recessionary**. Given that most developing governments in distress are also facing large fiscal imbalances, dollarization will trigger a draconian adjustment. Such an adjustment will lead to a recession, as government spending is slashed. Moreover, dollarization will lead to high real interest rates. It is true that dollarization lowers nominal interest rates. However, real interest rates will spike. Investors will demand compensation for political and economic risks. It is illogical to think that interest rates in an economy that is in the midst of an exchange rate crisis can automatically converge to U.S. interest rates.
3. **Dollarization subordinates bondholders.** Governments that dollarize transform international reserves into the monetary base. However, the elimination of international reserves is the removal of an asset that can be used to pay off international creditors. Under the assumption that the fiscal deficit creates an inflation tax on local currency holders, then external bondholders have a senior claim on the

country. Unfortunately, dollarization bumps local currency holders up the seniority ladder and allows them to be paid prior to the external creditors.

4. **Dollarization limits the development process.** Dollarized governments fail to develop the skills and experience needed to develop macroeconomic policies to manage the different phases of the business cycles. Dollarization is a pessimistic view on the capability of a society to fully develop.
5. **There are no reasonable exit strategies.** Assuming a country successfully dollarizes, how does it end dollarization? Governments dollarize when their societies have lost all confidence in their ability to implement macroeconomic policies. However, how do they segue into a new currency regime without renewing all of the doubts that existed prior to the dollarization initiative?

Argentina and Ecuador

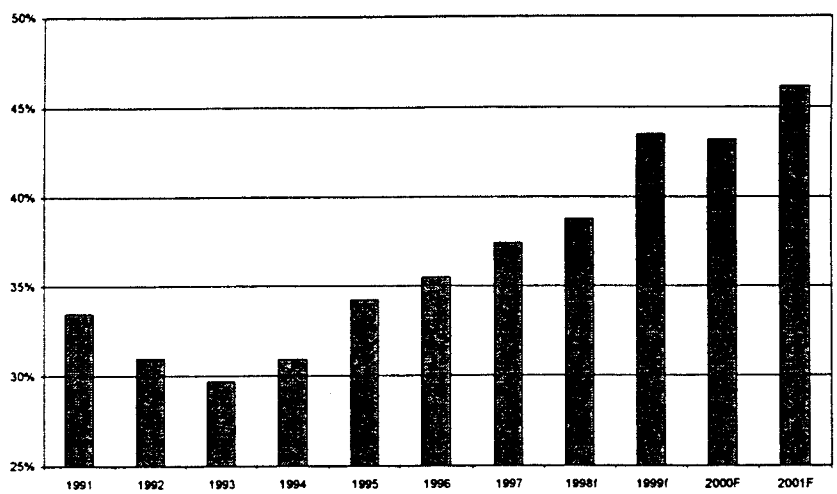
We examine the cases of Argentina and Ecuador to better understand some of the arguments that were presented against dollarization. The cases will show that governments consider dollarization use it only as a short-term solution to ensure survival.

Argentina:

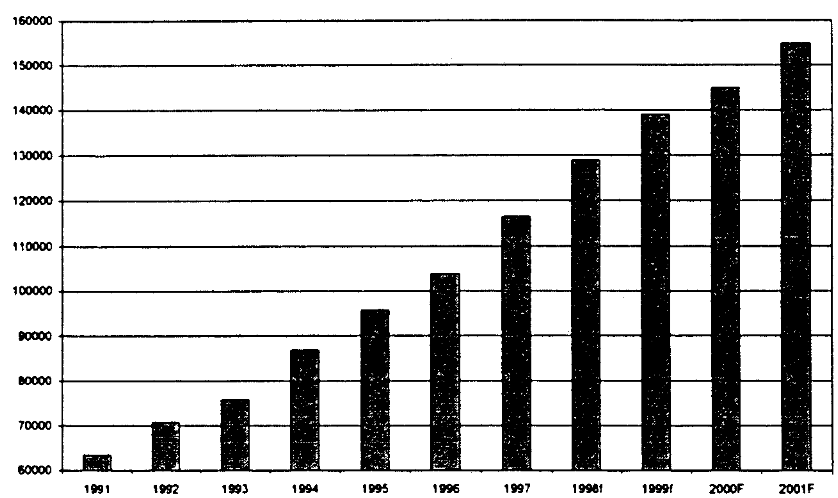
Argentina ended the 1980s in the midst of the worst economic crisis since the Great Depression. A weak Executive along with rent seeking by organized political groups, such as labor unions, industrialists and the provincial governments, undermined the government's ability to exercise prudent macroeconomic management. In an attempt to stabilize the economy, Argentina instituted the Convertibility Plan in March 1991. The currency board produced rapid results. It also provided the government with the time needed to pass important fiscal reforms, including an extensive privatization program. For the next eight years the Argentine government pursued further fiscal reforms. The cost of adjustment was high, but much of it was financed through real increases in government spending and external debt. For example, foreign debt rose 118% between

1991 and 1999 to $140 billion. The Debt to GDP ratio increased from 33% of GDP to 43% of GDP in the same time period.

Argentine Debt to GDP Ratio (1991-2001f)



Argentine Foreign Debt (in $Billions)



The Convertibility Plan faced several tests. The most important test occurred in 1995 during the so-called Tequila Crisis. A run on the banks and a rapid decline in international reserves almost precipitated a collapse of the currency board. However, multilateral commitment helped restore investor confidence. By 1999, the international community had confidence in the country. The devaluation of the Brazilian Real in January 1999 raised some doubts about the currency regime. However, most analysts were convinced that the government would take the appropriate fiscal measures to ensure the survival of the Convertibility Plan. Unfortunately, the country was starting its presidential campaign process. Therefore, the government was in no hurry to reduce government expenditures. In fact, the government waited until April 1999 before implementing a mild fiscal adjustment.

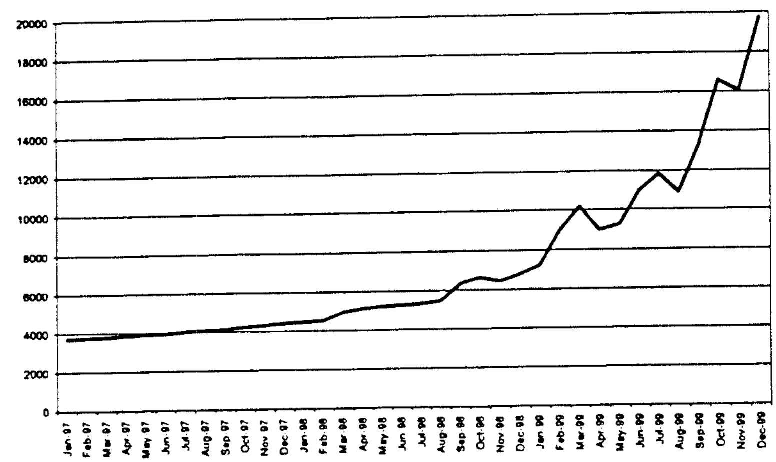
Faced with a loss of credibility, investors began pulling out of the country. Most of the damage was seen in the price of Argentine bonds. The government had a very difficult time in raising money in the international capital markets during the second half of 1999. It was at this time that the government began considering dollarization. Faced with a time horizon of less than six months, Argentine officials understood that dollarization would buy them sufficient time to end the term. The true solution to the crisis would have been a deep adjustment to the fiscal accounts. However, this would have further reduced the electoral prospects for the incumbent party. Instead, dollarization was a method of circumventing the appropriate policy response.

Ecuador:

Like other Latin American countries, Ecuador suffered serious political and economic problems in the 1980s and 1990s. In addition to a weak Executive and an overbearing congress, the country elected a succession of minority presidents in the late 1990s. It was evident that the country needed to implement extensive fiscal reforms, such as reducing subsidies and privatizing state-owned companies. However, well-entrenched political groups blocked each attempt to implement the economic reforms. As a result, the country witnessed steady erosion of its fundamental macroeconomic variables.

In 1998, El Niño, the drop in oil prices and the collapse of the banking sector put the country on the trajectory to a more serious crisis. The crisis arrived in September 1999, when the country defaulted on its foreign debt. The country lost all access to external credit. The currency plunged 200% in 1999, evaporating real wages. Social unrest increased in November 1999. Faced with the imminent collapse of the government, the Executive called for dollarization. Yet, there were no calls for fiscal reform or privatization. Instead, the government focused on the technical process to replace the money supply with the reserves in the central bank. Like the Argentine case, dollarization was a last ditch effort to buy time for political survival.

Ecuadorean Exchange Rate (Jan 97-Dec 99)



Conclusion

Dollarization is an interesting theoretical construct that is not grounded in political-economic reality. While most economists shrug political issues away, investors have to include all social considerations in their assessment. Dollarization is a one-sided look at the problem. It is an attempt to nominally fix the macroeconomic variables in the hope that all of the real structural changes needed to sustain the program will fall into place. Unfortunately, dollarization is not a solution to the institutional flaws that led to the crisis in the first place. It does nothing to shape the political will needed to sustain the exchange rate regime. Indeed, dollarization is only considered when countries are in distress and the government is desperate for political survival. Like all exchange rate stabilization programs, dollarization is an expeditious solution that front-loads all of the benefits of adjustment while backloading most of the costs. Politicians hope that the costs will be realized once their term is over. Unfortunately, investors have to deal with the long-term consequences.